

§ 1.1362-3

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for example, mortgage servicing fees, interest earned on mortgages prior to sale of the mortgages, and gain on sale of mortgages. In addition, S receives, from the investment of idle funds in short-term securities, \$15,000 of gross interest income and \$5,000 of gain.

(ii) S's gross receipts are calculated as follows:

\$100,000	Gross receipts from operations
15,000	Gross interest receipts
5,000	Gain on sale of securities
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120,000	Total gross receipts

(iii) S's passive investment income is determined as follows:

\$15,000	Gross interest receipts
5,000	Gain on sale of securities,
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20,000	Total passive investment income

(iv) S's passive investment income percentage for its first year as an S corporation is 16.67% (\$20,000/\$120,000). This does not exceed 25 percent of S's gross receipts and consequently the three-year period described in section 1362(d)(3) does not begin to run.

[T.D. 8449, 57 FR 55449, Nov. 25, 1992; 58 FR 15274, Mar. 22, 1993, as amended by T.D. 8869, 65 FR 3854, Jan. 25, 2000; T.D. 8995, 67 FR 34610, May 15, 2002]

§ 1.1362-3 Treatment of S termination year.

(a) *In general.* If an S election terminates under section 1362(d) on a date other than the first day of a taxable year of the corporation, the corporation's taxable year in which the termination occurs is an S termination year. The portion of the S termination year ending at the close of the day prior to the termination is treated as a short taxable year for which the corporation is an S corporation (the *S short year*). The portion of the S termination year beginning on the day the termination is effective is treated as a short taxable year for which the corporation is a C corporation (the *C short year*). Except as provided in paragraphs (b) and (c)(1) of this section, the corporation allocates income or loss for the entire year on a pro rata basis as described in section 1362(e)(2). To the extent that income or loss is not allocated on a pro rata basis under this section, items of income, gain, loss, deduction, and credit are assigned to each short taxable year on the basis of the corporation's normal method of accounting as determined under section 446. See, however, § 1.1502-76(b)(1)(ii)(A)(2) for special rules for an S election that terminates under

section 1362(d) immediately before the S corporation becomes a member of a consolidated group (within the meaning of § 1.1502-1(h)). See § 1.460-4(k)(3)(iv)(D) for rules relating to the computation of the S corporation's income or loss from a contract accounted for under a long-term contract method of accounting in the S termination year.

(b) *Allocations other than pro rata—(1) Elections under section 1362(e)(3).* The pro rata allocation rules of section 1362(e)(2) do not apply if the corporation elects to allocate its S termination year income on the basis of its normal tax accounting method. This election may be made only with the consent of each person who is a shareholder in the corporation at any time during the S short year and of each person who is a shareholder in the corporation on the first day of the C short year. See § 1.1362-6(a) for rules concerning the time and manner of making this election.

(2) *Purchase of stock treated as an asset purchase.* The pro rata allocation rules of section 1362(e)(2) do not apply with respect to any item resulting from the application of section 338.

(3) *50 percent change in ownership during S termination year.* The pro rata allocation rules of section 1362(e)(2) do not apply if at any time during the S termination year, as a result of sales or exchanges of stock in the corporation during that year, there is a change in ownership of 50 percent or more of the issued and outstanding shares of stock of the corporation. If stock has already been sold or exchanged during the S termination year, subsequent sales or exchanges of that stock are not taken into account for purposes of this paragraph (b)(3).

(c) *Special rules—(1) S corporation that is a partner in a partnership.* For purposes of section 706(c) only, the termination of the election of an S corporation that is a partner in a partnership during any portion of the S short year under § 1.1362-2 (a) or (b), is treated as a sale or exchange of the corporation's entire interest in the partnership on the last day of the S short year, if—

(i) The pro rata allocation rules do not apply to the corporation; and

(ii) Any taxable year of the partnership ends with or within the C short year.

(2) *Tax for the C short year.* The taxable income for the C short year is determined on an annualized basis as described in section 1362(e)(5).

(3) *Each short year treated as taxable year.* Except as otherwise provided in paragraph (c)(4) of this section, the S and C short years are treated as two separate years for purposes of all provisions of the Internal Revenue Code.

(4) *Year for carryover purposes.* The S and C short years are treated as one year for purposes of determining the number of taxable years to which any item may be carried back or forward by the corporation.

(5) *Due date for S short year return.* The date by which the return for the S short year must be filed is the same as the date by which the return for the C short year must be filed (including extensions).

(6) *Year in which income from S short year is includible.* A shareholder must include in taxable income the shareholder's pro rata share of the items described in section 1366(a) for the S short year for the taxable year with or within which the S termination year ends.

(d) *Examples.* The provisions of this section are illustrated by the following examples:

Example 1. S termination year not created. (i) On January 1, 1993, the first day of its taxable year, a subchapter C corporation had three eligible shareholders. During 1993, the corporation properly elected to be treated as an S corporation effective January 1, 1994, the first day of the succeeding taxable year. Subsequently, a transfer of some of the stock in the corporation was made to an ineligible shareholder. The ineligible shareholder still holds the stock on January 1, 1994.

(ii) The corporation fails to meet the definition of a small business corporation on January 1, 1994, and its election is treated as having terminated on that date. See § 1.1362-2(b)(2) for the termination rules. Because the corporation ceases to be a small business corporation on the first day of a taxable year, an S termination year is not created. In addition, if the corporation in the future meets the definition of a small business corporation and desires to elect to be treated as an S corporation, the corporation is automatically granted consent to reelect before the expiration of the 5-year waiting period.

See § 1.1362-5 for special rules concerning automatic consent to reelect.

Example 2. More than 50 percent change in ownership during S short year. A, an individual, owns all 100 outstanding shares of stock of S, a calendar year S corporation. On January 31, 1993, A sells 60 shares of S stock to B, an individual. On June 1, 1993, A sells 5 shares of S stock to PRS, a partnership. S ceases to be a small business corporation on June 1, 1993, and pursuant to section 1362(d)(2), its election terminates on that date. Because there was a more than 50 percent change in ownership of the issued and outstanding shares of S stock, S must assign the items of income, loss, deduction, or credit for the S termination year to the two short taxable years on the basis of S's normal method of accounting under the rules of paragraph (b)(3) of this section.

Example 3. More than 50 percent change in ownership during C short year. A, an individual, owns all 100 outstanding shares of stock of S, a calendar year S corporation. On June 1, 1993, A sells 5 shares of S stock to PRS, a partnership. S ceases to be a small business corporation on that date and pursuant to section 1362(d)(3), its election terminates on that date. On July 1, 1993, A sells 60 shares of S stock to B, an individual. Since there was a more than 50 percent change in ownership of the issued and outstanding shares of S stock during the S termination year, S must assign the items of income, loss, deduction, or credit for the S termination year to the two short taxable years on the basis of S's normal method of accounting under the rules of paragraph (b)(3) of this section.

Example 4. Stock acquired other than by sale or exchange. C and D are shareholders in S, a calendar year S corporation. Each owns 50 percent of the issued and outstanding shares of the corporation on December 31, 1993. On March 1, 1994, C makes a gift of his entire shareholder interest to T, a trust not permitted as a shareholder under section 1361(c)(2). S ceases to be a small business corporation on March 1, 1994, and pursuant to section 1362(d)(2), its S corporation election terminates effective on that date. As a result of the gift, T owns 50 percent of S's issued and outstanding stock. However, because T acquired the stock by gift from C rather than by sale or exchange, there has not been a more than 50 percent change in ownership by sale or exchange of S that would cause the rules of paragraph (b)(3) of this section to apply.

[T.D. 8449, 57 FR 55452, Nov. 25, 1992, as amended by T.D. 8842, 64 FR 61205, Nov. 10, 1999; T.D. 9137, 69 FR 42559, July 16, 2004]